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Ratings

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Research Update:

Flughafen Zurich AG Upgraded To 'AA-' On Cruising Operational And Financial Performance; Outlook Stable

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Overview

- Switzerland-based airport Flughafen Zurich AG (FZAG) is likely to deliver in 2018 another year of solid operating and financial performance through its aviation, retail, and real estate activities.
- We expect Zurich will maintain a solid financial risk profile over the next three years while continuing to finance capital expenditure (capex), overseas investments, and shareholder returns.
- With the Circle project, we expect FZAG management team, their partner Swiss Life, and shareholders (notably the Canton of Zurich) will be supportive of the on-time and on-budget delivery of the construction project.
- We are therefore raising our long-term rating on FZAG to 'AA-' and raising the stand-alone credit profile to 'a+' from 'a'. We are maintaining our expectation of a moderate likelihood that FZAG will receive extraordinary government support in case of need.
- The stable outlook on FZAG reflects our view that FZAG will maintain good operating performance and will be able to manage its capex program and international acquisitions while maintaining solid financial metrics.

Rating Action

On April 30, 2018, S&P Global Ratings raised the long-term issuer credit rating and issue ratings on Flughafen Zurich AG (FZAG) to 'AA-' from 'A+'. The outlook is stable.

Rationale

The upgrade reflects our expectations that FZAG's strong free operating cash flow (FOCF) and balance sheet should enable the group to maintain solid operational and financial performance, despite the elevated growth in capital expenditure (capex) and some potential additional international acquisitions. We expect funds from operations (FFO) to debt will remain solidly above 35% in 2018-2020 but FOCF will decline until the completion of the Circle project.

We anticipate that FZAG's earnings will benefit from another year of strong traffic performance in 2018 following a solid 6.3% growth in 2017. We understand aeronautical charges will remain flat until 2020 and therefore we expect aeronautical revenues will grow in line with traffic.

We anticipate that commercial earnings will increase in 2018, driven by new duty-free contracts, despite a trend of lower retail spending per passenger. We expect commercial earning will then remain relatively flat, subject to a relatively strong Swiss franc (CHF) and the absence of geopolitical or other type of shock.

We maintain our view of FZAG's strong competitive position as the only airport infrastructure serving the large and wealthy Zurich catchment area. FZAG supports the point-to-point market, as well as connecting traffic, mainly through the Swiss/Lufthansa group (63% of traffic if we also include Edelweiss [5.9%] and Eurowings [2.8%]). Although this creates significant exposure to a single airline group's performance, we consider that FZAG's core demand would in all probability be served by another major airline group in the unlikely event of Swiss/Lufthansa suffering a major downturn. The airport was minimally affected by the collapse of its second-largest carrier, Air Berlin, in 2017, for which traffic was quickly picked up by Swiss and low-cost carriers, namely EasyJet and Vueling.

In addition, FZAG operates under a regulatory framework that we view as supportive, although we expect aeronautical charges to remain flat until 2020.

The group has a well-diversified revenue base that includes retail operations, which are outside the regulated scope but have earnings upside potential. Aviation represented 58.4 % of revenues as of December 2017, with commercial businesses representing 38.7% of revenue. In 2018, we do not expect significant changes to the aero/commercial mix. On the other hand, while the international revenue of FZAG represented only 2.9% of revenues in 2017, we expect a significant increase in 2018, once revenues generated by the Florianopolis concession contract are fully factored in.

Although FZAG's real estate and aeronautical capex program could bring some earnings upside in the medium to long term, they are also going to increase leverage on the group's balance sheet in the short to medium term, particularly as the group is committed to maintaining its 40% payout ratio and has signaled an additional dividend of CHF100 million per year in 2018-2020. The high level of regulated capex (approximately CHF0.4 billion for 2018-2020)and nonregulated capex (approximately CHF0.6 billion for 2018-2020) makes FZAG more susceptible to traffic shocks and credit market deterioration, which could make the rating more volatile.

Further international acquisitions in 2018 are still likely. Although these acquisitions can provide additional growth and regional diversification, they expose FZAG to higher country and currency risks. We expect the focus of the FZAG will be on the successful delivery of the Circle project and other growth capex projects in the terminals precinct and on the apron.

S&P Global Ratings-adjusted EBITDA, at CHF572.2 million, an increase of 1%

compared with 2017. The adjusted EBITDA margin stayed stable at 56%. For 2018-2020, our base-case operating scenarios assume:

- Switzerland's real GDP increasing by 2.3% in 2018 and 1.7% in 2019. Consumer price index increasing by 0.7% in 2018 and 0.9% in 2019.
- Annual passenger volume growth for FZAG of 2.7%-3.6% in 2018-2020 based on a multiplier of GDP growth and guidance from carriers.
- A strong relationship remains between GDP growth rates and passenger numbers at the airport and their retail activity.
- Flat aeronautical tariffs in the 2018-2020 period as per the outcome of the regulatory review.
- Revenues per departing passenger declining slightly from CHF8.0 in 2017 to CHF7.6-CHF7.8 in 2018-2020
- Real estate revenue growing only modestly until the opening of the Circle in 2020.
- Heavy capex program of CHF1.1 billion for 2018-2020, partly debt-funded.
- Dividends of CHF200 million per year, including an additional dividend of CHF100 million
- We are also factoring potential acquisitions into our forecast period of about CHF150 million per year in 2019-2020.

Based on our assumptions, we expect weighted-average credit metrics will remain in line with our current financial risk profile assessment:

- S&P Global Ratings-adjusted FOCF/debt declining to about 10% by 2020.
- S&P Global Ratings-adjusted FFO to debt at about 39%-57.6% in 2018-2020.

To incorporate the strengths and the resilience of FZAG's financial risk profile, we raise the group's stand-alone credit profile (SACP) by one notch to 'a+' from 'a'.

We add one notch of uplift to FZAG's SACP to reflect what we see as a moderate likelihood of timely and sufficient extraordinary support by the Canton of Zurich, FZAG's largest single shareholder.

We base our view of a moderate likelihood of government support on our assessment of FZAG's:

- Strong link with the Canton of Zurich. The canton remains a significant shareholder, despite its relatively low stake (33.3% plus one share). The obligation of the canton to hold more than one-third of FZAG's shares, and hence to maintain its influence over FZAG as a shareholder, is stated in the law, in the Airport Act. We also base our view of the strong link on signs that the government is committed to providing timely and sufficient support to the airport in the event of financial distress.
- Role being of limited importance for the canton. In our opinion, the canton appears more interested in maintaining operations at the airport

than in taking measures to maintain or improve FZAG's creditworthiness.

Liquidity

We consider FZAG's liquidity to be strong, mainly deriving from ample liquidity sources on hand (such as the undrawn long-term revolving credit facility and available cash holdings), its ability to generate solid FOCF, and its demonstrated access to debt markets. These sources compare favorably with liquidity uses, in particular high capex. We expect liquidity sources will cover uses by at least 1.5x over the next year and by more than 1.0x over the following year.

We estimate liquidity sources for the 12 months from March 31, 2018, as follows:

- Unrestricted cash and fixed-term deposits of CHF587 million. We exclude the cash held in the Airport of Zurich Noise Fund.
- Availability of CHF238 million under a committed credit line due 2019.
- Cash FFO of CHF475 million-CHF500 million under our base-case scenario.

We estimate major liquidity uses for the 12 months from March 31, 2018, to comprise:

- No material debt maturities (only about CHF1.5 million).
- Capex of about CHF350 million for the upgrade and expansion of the airport's infrastructure and the Circle. In our liquidity calculation for FZAG, we do not include insurer Swiss Life's capex commitment to the Circle project because we consider that the investment-grade rated Swiss Life Group (operating companies rated A/Stable/--) has sufficient liquidity sources to fund its commitments.
- Dividends of about CHF200 million (including the additional dividend of about CHF98 million).
- Acquisitions of about CHF150 million, reflecting the company's plans to purchase minority stakes in other airports.

Outlook

The stable outlook on FZAG reflects our view that it will maintain its solid operating performance and will be able to manage its capex program and future acquisitions while maintaining credit metrics commensurate with its current credit quality. Specifically, we expect its adjusted FFO to debt will remain above 35% and the FOCF to debt will decline no further than 10% in the 2018-2020 period.

Downside scenario

We could lower the rating should business or financial performance deteriorate, notably if FFO to debt falls below 35% or if FOCF to debt becomes negative because of a higher level of investments or acquisitions than we assumed in our base case, particularly if the Circle project goes over time or over budget. Geopolitical challenges and consequent drop in traffic or increase in country risk (related to international activities) might also impede operating performance and thus the rating, although we see the probability of these as low. A quick appreciation of the CHF versus the euro could also affect passenger sales and thus put pressure on the rating. Finally, all else being equal, a one-notch downgrade on the Canton of Zurich may result in a similar action on FZAG.

Upside scenario

We see further upside as limited while the construction of the Circle is ongoing. For a one-notch upgrade to the rating, the SACP would need to be raised by at least two notches, all else being equal, which we see as remote over the next two years.

Ratings Score Snapshot

Issuer Credit Rating: AA-/Stable

Business risk: Strong
- Country risk: Very low
- Industry risk: Low
- Competitive position: Strong

Financial risk: Modest
- Cash flow/leverage: Modest

Anchor: a

Modifiers
- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Positive (+1 notch)
- SACP: a+
- Sovereign rating: AAA/Stable/--
- Likelihood of government support: Moderate (no impact)

Related Criteria

- General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Industrials: Key Credit Factors For The Transportation Infrastructure Industry, Nov. 19, 2013
- General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Upgraded; Outlook Action

	To	From
Flughafen Zurich AG		
Corporate Credit Rating	AA-/Stable/--	A+/Positive/--
Senior Unsecured	AA-	A+

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44)

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